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Section 1031 tax deferred exchanges—a review of the final regulations

By Martin S. Edwards, Chicago

Tax deferred exchanges of real estate have been recognized by the Internal Revenue Code since the 1920s. A variety of factors have converged the past several years leading to a dramatic increase in the popularity of tax deferred exchanges as an alternative to real property sales. Two of the principal factors resulting in the current extensive use of exchanges are the loss of the favorable capital gain rates and the court's decision in *Starker v. U.S.,* 602 F.2d 1341 (9th Circuit 1979). The maximum 20 percent capital gain rate was discarded as a result of the Tax Reduction Act of 1986 and this change provided great incentive to seek an alternative to sale. Although simultaneous exchanges have been effectuated for a long time, as a result of the landmark *Starker* case it became possible to accomplish a valid exchange on a nonsimultaneous basis.

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Editor's note: Martin Edwards is president of North Star Deferred Exchange Corp., which in turn is part of the North Star Financial Corporation. His comments on the federal regulations issued for *Starker* exchanges is timely and newsworthy, as is Richard Bales' review of a new state statute. Mr. Bales has authored articles for earlier issues of *Real Property;* he is a title officer in the Wheaton office Chicago Title Insurance Company.

—RJG

The impact of the Underground Utility Facilities Damage Prevention Act on the real estate lawyer

By Richard F. Bales, Wheaton

Back in the fall of 1990, a construction worker inadvertently severed some underground utility lines, disrupting phone service in several DuPage County municipalities. At that time, the soon-to-be-enacted Underground Utility Facilities Damage Prevention Act (Ill. Rev. Stat., ch. 111 2/3, par. 1601, sec. 1 *et seq.* [1989], hereafter termed "Act") was touted as the solution to this type of problem. Effective January 1, 1991, it may very well have prevented breakdowns in utility service. Unfortunately, the enactment of this Act has resulted in unforeseen ramifications for the land surveyor—ramifications that can impact all real estate practitioners.

Succinctly stated, the Underground Utility Facilities Damage Prevention Act requires anyone who engages in "nonemergency excavation or demolition" to first notify the owners or operators of underground utility facilities, who in turn will mark the approximate location of the underground utilities. If a party fails to so notify the owners or operators, and subsequently damages any underground facilities, that part is subject to a fine of no more than $200, and also liable for the damage to the facilities.

Note that section 2.3 of the Act defines "excavation" as "any operation in which earth, rock, or other material in or on the ground is moved, removed, or otherwise displaced by means of any tools, power equipment or explosives, and includes, without limitation, grading, trenching, digging … ." Because of the broad definition, land surveyors must first

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After this case decision was rendered, a taxpayer would typically transfer property to a purchaser, deposit the proceeds in an escrow or trust account, and subsequently acquire property from a third-party seller. Placing the funds in an escrow or trust account served the dual purpose of avoiding the taxpayer being characterized in constructive receipt of the money (thereby triggering a sale) as well as providing security for the purchaser's contractual obligation to transfer selected replacement property to the taxpayer. Transactions structured in this manner were commonly referred to as Starker trusts.

The increased use of these trusts in the latter part of the 1980s raised many questions and problems. First, although the taxpayer relinquished and acquired properties, there was often no actual exchange between any two parties to the transaction. Second, the structure of these transactions was not based upon regulations but rather upon loosely derived conclusions stemming from a myriad of case decisions and revenue rulings. To compound matters, Starker trusts were being structured differently in various parts of the country.

In response to these problems, and others, the Internal Revenue Service and the Treasury Department promulgated proposed regulations in May of 1990. After an extended comment period, final regulations were published in May of 1991. The regulations codified many of the cases and revenue rulings and at the same time addressed many comments and questions raised by practitioners in this field. The following is a brief summary of the contents of the final regulations.

Section 1031 applies only to exchanges of property "held for productive use in trade or business or for investment." Owner occupied residential property does not qualify nor does property held for sale. Also excluded are stocks, bonds, securities, partnership interests and certificates of trust or beneficial interest. Although clearly the "trust or beneficial interest" exclusion was not specifically intended to apply to property held in Illinois land trusts, until an expected revenue ruling on this question is issued, it is considered unwise to exchange directly in or out of a land trust.

After the taxpayer's relinquished property is transferred to the purchaser (referred to as the taxpayer's transferee), the taxpayer must identify and receive replacement property within prescribed time limits. The identification must take place within 45 days of the transfer of the relinquished property. This time period includes the day of transfer and the end date cannot be extended regardless that the end date may fall on a holiday or a weekend. The replacement property must be transferred to the taxpayer within 180 days of the closing of the relinquished property or by the due date for filing (including extensions) of the taxpayer's tax return. This time period also begins the date of transfer and cannot be extended despite possibly falling on a non-business day.

Identification of replacement property takes place by written document, signed by the taxpayer, delivered in person, by mail, or by fax to any other person involved in the exchange. The replacement property must be described specifically using a legal description, street address, or distinguishable name. For property to be constructed, identification must be in "as much detail … as possible …." Conservative practitioners may wish to attach plans and specifications to this type of identification. Since the 45-day time period is somewhat restrictive, the regulations allow identification of up to three alternative properties without regard to market value. Under a different provision, an unlimited number of properties may also be identified so long as the aggregate fair market value does not exceed 200 percent of the fair market value of the relinquished property.

Incidental personal property which is customarily transferred as part of a particular type of commercial transaction does not need to be separately identified so long as the value of the personal property is not greater than 15 percent of the fair market value of the real property. An example of this would be the purchase of stoves and refrigerators as part of the purchase of an apartment building. This incidental property rule pertains to the lack of need to identify the personal property only. It does not mean that the potential tax consequences of the purchase of personal property may be disregarded.

When identifying property to be constructed, great care must be taken to acquire actual constructed property and not construction services. If constructed property is not completed by the time of transfer to the taxpayer, only the value as of the date of transfer may be used to offset gain. Any construction completed after the date of transfer consists of services and is not part of the exchange.

Actual or constructive receipt of funds by the taxpayer during the pendency of the exchange is now, and has always been, fatal to a valid exchange. Historically, paying interest to the taxpayer on deposited funds was not permitted because to do so was indicative that the taxpayer was in constructive receipt of the funds. Similarly, the Starker trustee or escrowee could not be the taxpayer's lawyer or accountant because such persons were the agents of the taxpayer. The regulations state the taxpayer is in actual receipt of the funds anytime the taxpayer receives the "economic benefit" of the money. The taxpayer is in constructive receipt when the funds are "credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it …." The area of actual and constructive receipt drew substantial attention in the final regulations.

The regulations suggest three basic ways to structure an exchange to avoid a possible determination of actual or constructive receipt. The term "safe harbor" is used in the regulations to describe these three structures. The first safe harbor permits the purchaser's obligation to provide replacement property to be secured by a mortgage, letter of credit or third-party guarantee. The second safe harbor secures the purchaser's obligation to furnish replacement property by placement of the funds in a qualified escrow or trust account. The practical problem with the first two safe harbors is that each requires the purchaser (the taxpayer's transferee) to be involved in the exchange to a greater extent than simply acquiring the relinquished property. Under these safe harbors, the purchaser must enter into a contract to purchase the replacement property, possibly take title to the property and reconvey it to the taxpayer. Most relinquished property buyers readily agree to nominally participate in an exchange but are unwilling to become involved to the extent required by the first two safe harbors.

The third safe harbor involves the use of a qualified intermediary. The intermediary not only safeguards the funds during the exchange period but also facilitates the exchange, making the relinquished property purchaser's involvement minimal. To perfect the exchange under this safe harbor, the qualified intermediary must either acquire title to the relinquished and replacement property or must enter into a contract with the relinquished property buyer and replacement property seller for the transfer of each property. Upon note to all parties, the necessary contract rights may vest in the intermediary as a result of an assignment of such contract from the taxpayer to the intermediary.

The qualified intermediary safe harbor has several interesting aspects. This relationship departs from general exchange rules regarding agency and expressly allows the intermediary to enter into the contracts as an agent of the taxpayer. Also use of the qualified intermediary is the only method recognized under the regulations for structuring a simultaneous exchange. Regardless of which safe harbor is used, once the taxpayer has any right to receive, pledge, borrow, or obtain the benefits of the funds, the safe harbor ceases to apply. Valid exchanges can be accomplished without the use of a safe harbor but they will be subject to very close scrutiny by the Internal Revenue Service.

The regulations also permit the payment to the taxpayer of interest or a "growth factor" without imputing constructive receipt. This interest is not part of the deferred exchange funds and is taxable to the taxpayer in the same manner as any other type of interest earned.

The last portion of the regulations deals with the definition of persons or entities disqualified from acting as qualified escrowee, trustee or intermediary. Essentially, anyone who has acted as the taxpayer's employee, attorney, accountant, investment banker, broker or real estate agent within two years prior to the transfer of the relinquished property is disqualified. There is an exception to this disqualification rule for providers of routine financial, title insurance, escrow or trust services. Entities within this group can act to facilitate an exchange without risk of being disqualified.

This article is intended to provide an overview of the current status of the section 1031 tax deferred exchange regulations. A detailed reading of the full regulations is recommended before attempting to represent a client in this area.

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call the owners or operations of underground utility facilities before they can dig for boundary monumentation! Such a prerequisite has in some instances prevented the surveyor from completing surveys in a timely fashion. The reasons fro this are at least two-fold: First of all, while section 10 of the Act states that the underground facilities will be marked within 48 hours of the receipt of notification by the excavator, delays in said marking have occurred. Secondly, the utility companies seem to reference the location of their utilities either by street address or by quarter section. When the surveyor has to survey Blackacre, which may or may not necessitate the location of ancillary monumentation hundreds of feet away, the end result is that the representative of the utility companies is forced to locate and mark everything in a very broad area. In many instances, in order to deliver the plat of survey in a timely manner, the surveyor is forced to schedule a meeting, at the property in question, between himself and this representative. Such a meeting cannot always be scheduled with 48 hours notice, which again creates delay.

It does not appear that the drafters of this legislation intended for surveyors to be bound by this Act. Again, note that "excavation" is defined in section 2.3 as the displacement of material "by means of any tools, *power* equipment …." (emphasis added). "Demolition," on the other hand, is defined in section 2.4 as "the wrecking … of a structure by means of any *power* tool, *power* equipment …." (emphasis added). It seems likely that only because of an oversight was the word "tools" used in section 2.3 in defining "excavation" not limited by the adjective "power"; such a limitation would be consistent with the rest of section 2.3 and with section 2.4.

It is because of this inconsistency that surveyors are currently bound by this legislation. A simple amendment to this Act, changing "tools" in section 2.3 to "power tools," would take the burden of this Act off of the shoulders of the surveyor, where it probably never was intended to be anyway. (Indeed, as presently written, the Act is applicable to not only surveyors, but also to the casual home gardener!)

This is not to infer that surveyors do not sometimes damage underground utilities. However, this may be more the fault of the utility company than the surveyor. Utility companies, it seems, are prone, more often than not, to install their underground utilities immediately adjacent to the lot lines of new subdivisions. This is the case, even though the utility company usually has an easement area of between five and 10 feet in width, adjacent to said lot line, in which to locate its utilities. When the surveyor comes in, usually after final grading, to set plat monumentation at, among other places, at least two corners of every lot, pursuant to Ill. Rev. Stat., ch. 09, par. 1, sec. 1(a) (1989), the surveyor many times risks damaging the newly installed utilities. If the utility companies wish to prevent this from happening, binding surveyors to the confines of the Underground Utility Facilities Damage Prevention Act is the wrong way to accomplish this goal. A simpler method might be to merely amend Chapter 109 of the Illinois Revised Statutes (the Plat Act) so that utility easements in